

REDACTED DECISION – DOCKET NO. 12-180 P

**By: MATTHEW R. IRBY, ADMINISTRATIVE LAW JUDGE
SUBMITTED FOR DECISION ON AUGUST 29, 2012
DECISION ISSUED ON FEBRUARY 25, 2013**

SYNOPSIS

TAX ADMINISTRATION -- DUTIES OF TAX COMMISSIONER -- It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).

TAXATION -- PROCEDURE AND ADMINISTRATION -- ASSESSMENT -- If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor. *See* W. Va. Code Ann. § 11-10-7(a) (West 2010).

TAXATION -- PERSONAL INCOME TAX -- When auditing for compliance with this article, the Tax Commissioner may change a taxpayer's computation of federal taxable income or pro forma taxable income to comply with the laws of the United States as in effect for the taxable year and incorporated by reference into this article. *See* W. Va. Code Ann. § 11-21-12g (d) (West 2010).

INTERNAL REVENUE SERVICE -- PUBLICATION -- TAXATION OF LIMITED LIABILITY COMPANIES -- In determining federal adjusted gross income, “[a]n LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes” IRS Pub. No. 3402, Taxation of Limited Liability Companies (Rev. March 2010).

INTERNAL REVENUE CODE -- DEFINITION -- FEDERAL ADJUSTED GROSS INCOME -- Federal adjusted gross income is simply a taxpayer’s gross income less specifically enumerated deductions in Internal Revenue Code Section 62(a). *See* 26 USC § 62(a) (2013).

INTERNAL REVENUE CODE -- DEFINITION -- ADJUSTED GROSS INCOME -- Under the Internal Revenue Code, “gross income means all income from whatever source derived, including . . . [g]ross income derived from business.” I.R.C. § 61(a)(2) (2013).

SUPREME COURT OF THE UNITED STATES -- DECISION -- The Supreme Court of the United States determined that gross income was “an undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion.” C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

TREASURY REGULATION -- DEFINITION -- GROSS INCOME DERIVED FROM BUSINESS -- “In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.” 26 C.F.R. § 1.61-3(a) (2013).

TAXATION -- PERSONAL INCOME TAX -- The West Virginia adjusted income of a resident individual is the “federal adjusted gross income as defined in the laws of the United States” for the taxable year with modifications allowed by West Virginia law. *See* W.Va. Code Ann. §11-21-12(a) (West 2010).

WEST VIRGINIA OFFICE OF TAX APPEALS -- BURDEN OF PROOF -- In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is on the Petitioner to show that any assessment of tax against it is erroneous, unlawful, void, or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e), W. Va. Code R. §§ 121-1-63.1 and 69.2 (2003).

PERSONAL INCOME TAX -- BURDEN OF PROOF -- Where an assessment is based on a methodology developed to estimate the amount of tax due, to satisfy its burden of proving that the assessment is erroneous, a taxpayer may not merely question the methodology of the assessment, but must provide credible evidence to support his position.

CONSUMERS SALES AND SERVICE TAX, SALES AND USE TAX & PERSONAL INCOME TAX -- BURDEN OF PROOF NOT MET -- The Petitioner failed to satisfy his burden of proof by reason of his failure to provide evidence to show the actual amount of his sales for purposes of the personal income tax.

FINAL DECISION

A tax examiner with the Field Auditing Division (hereinafter Division) of the West Virginia State Tax Commissioner’s Office (Tax Commissioner or Respondent) conducted an audit of the books and records of the Petitioner’s LLC, Company A¹. Thereafter, on March 26, 2012, the Director of this Division issued a personal income tax assessment against the Petitioner. The assessment was issued pursuant to the authorization of the State Tax Commissioner, under the provisions of Chapter 11, Articles 10 and 21 of the West Virginia

¹ This audit was conducted jointly with a consumers sales and service tax audit of the LLC. The facts and evidence presented in that matter in Docket No. 12-179 CU were made a part of this record, as the assessments are based upon the same general findings: that the Petitioner was underreporting sales, and thereby gross revenue.

Code. The assessment was for the period January 1, 2009, through December 31, 2011, for tax in the amount of \$____ and interest in the amount of \$____, for a total assessed tax liability of \$____. Written notice of this assessment was served on the Petitioner as required by law.

Thereafter, on May 3, 2012, the Petitioner timely filed with this Tribunal, the West Virginia Office of Tax Appeals, a petition for reassessment. *See* W. Va. Code Ann. §§ 11-10A-8(1); 11-10A-9 (West 2010)

Subsequently, notice of a hearing on the petition was sent to the Petitioner, and a hearing was held in accordance with the provisions of West Virginia Code Section 11-10A-10.

FINDINGS OF FACTS

1. Company A is a single member limited liability company consisting solely of the Petitioner, Mr. A, who lives in, and engages in the business of operating a bar in a West Virginia city, in a West Virginia County..

2. On or about March 6, 2012, the auditors began to perform an audit in this matter, and the Petitioner provided “z” tapes² from the cash register used when operating the bar, particularly for the 2010 tax year, which was used as a sample tax year.

3. The auditors noted a number of discrepancies in the cash register tapes, including a large percentage of so-called “no sales” by the bar on a daily basis.

4. The auditors also added up the distributor records to determine the amount of alcohol that was purchased, both beer and liquor.

² A “z” tape is a cash register tape that is normally run at the end of the day showing a summary of that day’s sales, sometimes broken down by category. It will show consumers sales and service tax collected, and if there were any “void sales” or “no sales,” and the amount of any void sales.

5. With regard to the liquor purchased, the auditors determined that seventeen shots can be made from a “fifth” of liquor³, and then reduced the number to fifteen drinks to account for spillage⁴.

6. The auditors then added the beer purchases and the liquor drinks available, and determined the amount of alcohol purchased did not match up at all with the amount of alcohol sold according to the cash register tapes.

7. The auditors thus determined that the business did not keep complete and accurate records of all sales in the business.

8. Upon visiting the taxpayer’s business on two separate days, March 16, 2012, and March 21, 2012, the auditors determined that the beer sold for, between \$2.25 for Stroh’s and Budweiser, and \$3.00 for Corona. The bartender reported to the auditors that the liquor was priced between \$3.00 and \$7.00.

9. The business also purchased a number of other items, and sold them at its business location in wide ranging prices, as determined by the auditors during their field visits on March 16, 2012, and March 21, 2012⁵. The auditors also detailed food purchases by applying a markup of two hundred percent based on prior audit experience.

10. The auditors then determined what percentage of sales of food and beverages were attributable to gross sales for the 2010 tax year. The auditors then determined the percentage of underreporting of those particular sales for that given year. The auditors then

³ It was noted by the auditors, that a significant amount of the liquor purchased wholesale was actually 1liter bottles, which are thirty-three percent larger than a “fifth” of liquor.

⁴ It was also noted by the auditors that the seventeen-drink figure was already a number that was reduced for spillage.

⁵ The auditors acknowledged that they used 2012 prices in determining the price of the food and other items, and that the price may therefore be overstated.

applied that calculation to the food and beverage sales to determine the amount of underreporting per year, minus the included sales tax⁶.

11. The auditors then attributed the underreported sales as gross income to the Petitioner's West Virginia adjusted gross income, which effectively increased the tax the Petitioner was required to pay.

DISCUSSION

As noted in this Tribunal's decision in Docket No. 12-179 CU, based upon the survey conducted, the auditors for the Respondent determined the amount of alcohol sales that were underreported, reduced that number by an included sales tax, and then determined the percentage that the business underreported for the sample year. The auditors then applied that sample underreporting percentage to the other tax years covered by the audit to determine the amount of underreported sales for the period of the audit. Next, the auditors included that number into the Petitioner's Schedule C⁷, which resulted in an upward recalculation of the Petitioner's federal adjusted gross income, and by extension an upward recalculation of his West Virginia adjusted gross income.

As a result of this Tribunal's determination that the recalculation of gross sales was not improper, the only question left to be resolved is whether the Tax Commissioner properly issued a personal income tax assessment based on that increase in gross sales.

Under West Virginia Code Section 11-21-12(a), the West Virginia adjusted income of a resident individual means his or her federal adjusted gross income as defined in the laws of the

⁶ The auditor "backed the sales tax" out of the reported figure, stating that she knew the sales tax was included into the gross sales price.

⁷ The Schedule C is the profit or loss from business statement required to be filed by a sole proprietorship with a taxpayer's regular personal income tax return.

United States for the taxable year with modifications allowed by West Virginia law. *See* W. Va. Code Ann. § 11-21-12(a) (West 2010). Therefore, since the West Virginia adjusted gross income is based primarily on federal adjusted gross income, the initial question for determination is whether the Tax Commissioner is authorized to adjust the reported federal adjusted gross income, as reported by the Petitioner.

To that end, the West Virginia Code provides that:

If the tax commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor.

W. Va. Code Ann. § 11-10-7(a) (West 2010). Additionally, the Legislature provided a specific avenue for adjustment to the personal income tax, by providing:

When auditing for compliance with this article, the Tax Commissioner may change a taxpayer's computation of federal taxable income or pro forma taxable income to comply with the laws of the United States as in effect for the taxable year and incorporated by reference into this article.⁸

W. Va. Code Ann. §11-21-12g(d) (West 2010).

Therefore, the Tax Commissioner is clearly authorized to change a taxpayer's computation of federal adjusted gross income during an audit, in order to properly assess the

⁸ The computation for West Virginia taxable income begins with Federal Adjusted Gross Income. However, this section allows the Tax Commissioner to change the computation of taxable income. This tribunal notes that the legislature intended to authorize the Tax Commissioner to adjust federal adjusted gross income for the purposes of determining West Virginia taxable income. Since the computation of federal taxable income requires an adjustment to federal adjusted gross income in the instant case, the statute is sufficient to allow the Tax Commissioner to make the appropriate adjustment in this case.

taxpayer under the West Virginia personal income tax⁹. However, such adjustment must comply with the laws of the United States. Thus, the next question for determination is whether the Tax Commissioner properly calculated the taxpayer's federal adjusted gross income, and by extension, the taxpayers West Virginia adjusted gross income.

In determining the federal adjusted gross income, the Internal Revenue Service has issued guidance, by stating “[a]n LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes.” IRS Pub. No. 3402, Taxation of Limited Liability Companies (Rev. March 2010). Thus, the calculation of adjusted gross income is determined as if the taxpayer was an individual.

Adjusted gross income is simply a taxpayer's gross income less specifically enumerated deductions in Internal Revenue Code Section 62(a). *See* 26 USC § 62(a) (2013). Since the taxpayer provided no evidence of any allowable deductions under that section, a determination of this taxpayer's gross income will also provide the appropriate federal adjusted gross income.

So, under the Internal Revenue Code, “gross income means all income from whatever source derived, including . . . [g]ross income derived from business.” I.R.C. § 61(a)(2) (2013). In its seminal case on gross income, the Supreme Court of the United States determined that gross income was “an undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion.” C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Additionally, the Code of Federal Regulations provides that:

In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any

⁹ To the extent this determination conflicts with this tribunals finding in a Final Order in Docket No. 07-381 P, that Order is overruled.

income from investments and from incidental or outside operations or sources.

26 C.F.R § 1.61-3(a) (2013). Thus, since the Petitioner already reduced his gross income by his cost of goods sold, the increase in gross sales would simply carry forward as federal adjusted gross income to the Petitioner.

As noted above, since the Petitioner is a West Virginia resident, West Virginia Code Section 11-21-12 provides that the West Virginia adjusted gross income of a resident individual is the “federal adjusted gross income as defined in the laws of the United States” with modifications allowed by West Virginia law. W. Va. Code Ann. §11-21-12(a) (West 2010). Again, the increase in federal adjusted gross income would simply carry forward to his West Virginia income tax return, and thus increase the Petitioner’s liability for income tax.

CONCLUSIONS OF LAW

Based upon all the above, it is **DETERMINED** that:

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).
2. If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor. *See* W. Va. Code Ann. §11-10-7(a) (West 2010).
3. When auditing for compliance with this article, the Tax Commissioner may change a taxpayer's computation of federal taxable income or pro forma taxable income to

comply with the laws of the United States as in effect for the taxable year and incorporated by reference into this article. *See* W. Va. Code Ann. §11-21-12g (d) (West 2010).

4. In determining federal adjusted gross income, “[a]n LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes” IRS Pub. No. 3402, Taxation of Limited Liability Companies (Rev. March 2010).

5. Federal adjusted gross income is simply a taxpayer’s gross income less specifically enumerated deductions in Internal Revenue Code Section 61(a). *See* 26 USC § 62(a) (2013).

6. Under the Internal Revenue Code, “gross income means all income from whatever source derived, including . . . [g]ross income derived from business.” I.R.C. § 61(a)(2) (2013).

7. The Supreme Court of the United States determined that gross income was “an undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion.” C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

8. “In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.” 26 C.F.R. § 1.61-3(a) (2013).

9. The West Virginia adjusted income of a resident individual is the “federal adjusted gross income as defined in the laws of the United States” for the taxable year with modifications allowed by West Virginia law. W. Va. Code Ann. §11-21-12(a) (West 2010).

10. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is on the Petitioner to show that any assessment of tax against

it is erroneous, unlawful, void, or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (2012), W. Va. Code R. §§ 121-1-63.1 and 69.2 (2003).

11. Where an assessment is based on a methodology developed to estimate the amount of tax due, to satisfy its burden of proving that the assessment is erroneous, a taxpayer may not merely question the methodology of the assessment, but must provide credible evidence to support his position.

12. The Petitioner failed to satisfy his burden of proof by reason of his failure to provide evidence to show the actual amount of his sales for purposes of the personal income tax.

DISPOSITION

WHEREFORE, it is the **FINAL DECISION** of the West Virginia Office of Tax Appeals that the personal income tax assessment issued against the Petitioner for the period January 1, 2009, through December 31, 2011, for tax in the amount of \$___ and interest in the amount of \$___, for a total assessed tax liability of \$___, should be and is hereby **AFFIRMED**.

Pursuant to West Virginia Code Section 11-10-17(a), interest continues to accrue on the unpaid tax until this liability is fully paid.

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
A. M. "Fenway" Pollack¹⁰
Chief Administrative Law Judge

Date Entered

¹⁰ Administrative Law Judge, Matthew R. Irby, heard this matter and wrote this decision; however, Judge Irby is no longer employed with the West Virginia Office of Tax Appeals. Therefore, this decision was signed by Chief Administrative Law Judge A. M. "Fenway" Pollack.